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Theodore Berger

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TAXATION: HAS THE TIME COME FOR A NATIONAL TAX COURT?

THEODORE BERGER*

The concept of a national court of tax appeals, which has long been discussed, received its strongest impetus this year. Senator Kennedy, as chairman of the Senate Judiciary Committee, introduced the Federal Courts Improvement Act of 1979.¹ This legislation would establish a United States Court of Tax Appeals to have exclusive review jurisdiction in civil tax matters.² Jurisdiction of these cases would be removed from the other courts of appeals.³ The bill also removes the trial jurisdiction of the Court of Claims in tax matters.⁴ Thus, the United States Tax Court and the district courts would continue to share original jurisdiction of civil tax cases at the trial level.⁵ With a single reviewing court, there would no longer be the possibility of a conflict in decisions at the appellate level. Consequently, since conflict among the circuit courts has been the principal ground for the United States Supreme Court's grant of certiorari in tax cases,⁶ it can be anticipated that very few tax cases would reach the Supreme Court should the legislation be enacted into law.

The purposes for establishing a single reviewing court are to relieve the presently overburdened courts of appeal and, more importantly, to provide certainty and uniformity of interpretation of Internal Revenue Code provisions.⁷ Especially relevant to this article are the conflicting views of supporters of a national court regarding the selection of judges for the court.⁸ Senator Kennedy's bill envisions a rotat-

* Partner, Arnstein, Gluck, Weitzenfeld & Minow; B.S., Northwestern University; J.D., New York University.

1. S. 383, 96th Cong., 1st Sess. §§ 101-510 (1979).

2. *Id.* §§ 401, 407.

3. *Id.* § 404.

4. *Id.* § 341.

5. The United States Tax Court has jurisdiction under 26 U.S.C. § 7442 (1976) to review proposed deficiencies. Under 28 U.S.C. § 1346 (1976), the district courts and the Court of Claims have concurrent jurisdiction in tax refund suits.

6. *See, e.g.,* Commissioner v. *Binder*, 369 U.S. 499 (1972).

7. It may be of some interest to note that a questionnaire circulated among tax practitioners attending a meeting of the American Bar Association Section of Taxation in Washington, D.C. on May 19, 1979 voted 99 to 45 against establishment of a national court of tax appeals. *See* Redman, *Chairman's Report*, 32 TAX LAW. 877 (1979).

8. The group of practitioners referred to in note 7 *supra* voted 100 to 38 in favor of permanent judges in the event a national court of tax appeals was established.

ing panel of twelve judges taken from the other courts of appeals, each to serve a three year term.⁹ While approving the principle of a national reviewing court, the Department of the Treasury prefers a court composed of permanent judges which might be augmented from time to time by judges from other courts of appeal.¹⁰

The preference for rotating or permanent judges would reflect a prediction as to the type of tax cases likely to reach the docket of the national appeals court. Many tax cases require a common law approach to decision-making; for example, questions of when seemingly separate steps would be deemed part of a single transaction. Presumably, regular circuit court judges would be well qualified to decide such issues. Other cases would involve the complex interplay of Internal Revenue Code¹¹ provisions, a skill and expertise perhaps best developed by permanent judges.

Both types of cases are now handled by the circuit courts of appeals. Therefore, it is interesting in reviewing the tax decisions of the Seventh Circuit this past year¹² to consider whether appellate judges specializing in tax cases might have followed a different approach.

The number of tax decisions handed down by the Seventh Circuit during 1978-79 is perhaps too small a sample to reach precise conclusions regarding the direction of the court. Moreover, even this small sample represents the work of different panels of the court. Of the cases to be discussed, *Crown v. Commissioner*,¹³ *Ferris v. Commissioner*,¹⁴ and *Estate of Jenner v. Commissioner*¹⁵ each required interpretation of a single code provision.¹⁶ Consequently, the reviewing court was able to fall back on those principles of common sense which supposedly underpin the common law. On the other hand, the decision in *Koehring Co. v. United States*¹⁷ exemplifies the tangled statutory web which must often be penetrated to reach a decision in a tax case. The latter type of case may become more common as Congress enacts ever more complex code provisions.

9. S. 383, 96th Cong., 1st Sess. § 402 (1979).

10. For a further discussion of this proposed legislation, see Caplin & Brown, *A New United States Court of Tax Appeals*: S.678, 57 TAXES 360 (1979).

11. Hereinafter referred to as the code. References made to the code are to the Internal Revenue code of 1954, as amended.

12. Cases reviewed in this article are those decided from June 1, 1978 through May 31, 1979.

13. 585 F.2d 234 (7th Cir. 1978).

14. 582 F.2d 1112 (7th Cir. 1978).

15. 577 F.2d 1100 (7th Cir. 1978).

16. 583 F.2d 313 (7th Cir. 1978).

17. 585 F.2d 234 (7th Cir. 1978).

INTEREST-FREE LOANS TO FAMILY MEMBERS

Unquestionably, the most important case decided by the Seventh Circuit in the past year was the gift tax case of *Crown v. Commissioner*.¹⁸ *Crown* involved the fundamental question of whether interest-free loans to family members represented taxable gifts. The taxpayer and his two brothers were partners in a partnership which made loans totaling approximately \$18 million to a series of trusts which had been established for the benefit of the children and other relatives of the brothers. These loans were used by the trusts to acquire interests in another investment partnership. Most of the loans were on open account and some were represented by demand notes payable. No provision was made for the payment of interest, and none was paid. The Commissioner asserted gift tax deficiencies against each of the partners.¹⁹ This was based on the determination that interest-free loans by the partnership represented taxable gifts by each of the partners to the extent of the interest value which might have been charged. The Commissioner used a six percent interest rate applied to the daily balance of loans outstanding during the year to compute the amount of the gift.²⁰

The applicable provisions of the gift tax statute are very broadly worded. Section 2501²¹ of the code imposes a gift tax on any transfer of property by gift and section 2512(b)²² provides that where property is transferred for less than full and adequate consideration, the amount by which the value of the property exceeds the value of consideration shall be deemed a gift. Before the Tax Court, the Commissioner argued that a loan made without interest is a transfer of property at less than the true economic value. In other words, the lender has foregone the opportunity cost of the money and, to that extent, the lender makes a gift to the borrower.

With four judges dissenting, the Tax Court held for the taxpayer,²³ finding that the interest-free loans in *Crown* were non-taxable events under the gift tax statute.²⁴ The court noted that another tax case,

18. 582 F.2d 234 (7th Cir. 1978).

19. *Crown* involved loans outstanding in 1967. Gift tax returns were required to be filed for the calendar year prior to 1971. After 1970, the returns are to be filed quarterly. Where quarterly returns are to be filed, the computation would reflect loans outstanding during the quarter.

20. The Commissioner also contended in an income tax proceeding not related to this appeal that the imputed interest represented taxable income to the partners. 585 F.2d at 236 n.3.

21. I.R.C. § 2501.

22. *Id.* § 2512(b).

23. 67 T.C. 1060 (1977).

24. *Id.*

Johnson v. United States,²⁵ which held in the taxpayer's favor, was directly on point. The *Crown* court was also influenced by other income tax decisions²⁶ which held that no income was to be imputed simply because funds were being advanced without payment of interest. The Tax Court extended the principle by analogy to the gift tax area because the court was reluctant to upset an understanding of the law which had persisted for years.²⁷ The dissenting judges in *Crown*, on the other hand, found the economic advantage of such loans to be within the broad sweep of the gift tax statute.²⁸ The Commissioner appealed to the Seventh Circuit.

The Seventh Circuit affirmed the decision of the Tax Court. In so doing, the Seventh Circuit rendered an opinion that was more analytical than that of the Tax Court. The Seventh Circuit was disturbed both by the technical problem of whether there had been a transfer of a property right within the meaning of code section 2501²⁹ and by the practical problem of valuing the gift. These two aspects fuse because the approach to valuation follows from the determination of what rights, if any, had been transferred. If the making of the loan created a present right or interest in favor of the borrower, it would seem to follow that its value should be measurable at the time of the loan. If the property right is the right to the indefinite use of the money,³⁰ analogous to a tenancy at will, it would have to be shown that such right has an exchangeable value. Alternatively, if the gift is completed by the lender's failure to demand payment, the gift is continuous; its value is measured continuously during the period of time the loan is outstanding, and the tax is computed for each segment within this total period of time for which a gift tax return would be filed.³¹

The Seventh Circuit in *Crown* restated the Commissioner's argu-

25. 254 F. Supp. 73 (N.D. Tex. 1966).

26. *Saunders v. United States*, 294 F. Supp. 1276 (D. Hawaii 1968), *rev'd on other grounds*, 450 F.2d 1047 (9th Cir. 1971); J. Simpson Dean, 35 T.C. 1083 (1961).

27. The failure of the government to appeal the adverse decision in *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966), may have led to this supposed understanding of the law.

28. 585 F.2d at 241-42.

29. I.R.C. § 2501.

30. The loans were made to permit the trusts to enter into certain investments. While the court does not suggest it, there might have been found to be an implicit understanding that no demand would be made on the notes until these investments had generated sufficient income. The trusts presumably would not have been able to satisfy any demand before this time.

31. Under present law, gift tax returns need not be filed for a particular quarter until the quarter in which taxable gifts for the calendar year exceed \$25,000 or after the fourth quarter if this limitation has not been met. See I.R.C. § 6075(b).

ment to be that the lender has constructively received³² an interest payment which the lender then constructively transfers to the borrower. Under this view, the lender is being taxed on what he could have done rather than what he did. Further, the court noted that since the principal of the note was recoverable on demand, there would be no diminution of the estate tax otherwise payable on the lender's death. Thus, since the prime function of the gift tax is to prevent avoidance of estate tax,³³ the Seventh Circuit concluded that Congress did not necessarily intend to apply the gift tax in this situation.³⁴

The Seventh Circuit was not altogether satisfied with the result in *Crown* and, as a result, more or less invited the Commissioner to change the regulations under section 2501.³⁵ Specifically, the court wanted the Commissioner to determine that the imputed interest element of an interest-free loan constitutes a gift, or perhaps the Commissioner would encourage Congress to change the statute to that effect. While the Seventh Circuit was concerned that the taxing authorities had not consistently asserted a gift tax in this situation, the Commissioner had failed to appeal the only decision squarely on point.³⁶ Therefore, it is difficult to understand how a change in regulations would affect interpretation of the statute.³⁷

The Honorable Robert Van Pelt, senior district judge for the District of Nebraska, sitting by designation, wrote the dissenting opinion in *Crown*.³⁸ Judge Van Pelt relied on legislative history³⁹ which provided for a broad application of the gift tax statutes. Judge Van Pelt concluded his dissenting opinion with the feeling that the decision of the majority "just ain't right."⁴⁰

The difficulty which the *Crown* court had in determining the amount of the gift in the case of demand loans is not present where the notes are for a fixed term. There may be some difficulty in establishing the fair market value at which notes of this character might trade. However, if an interest rate can be assumed and the term is known, it is

32. Constructive receipt has a somewhat different connotation in income tax law. It refers to a receipt of cash, available to a taxpayer for the asking. See Treas. Reg. § 1.451-2 (1957).

33. There would, however, be a reduction in the estate by the amount of interest income foregone. This was the only amount which the Commissioner sought to subject to gift tax.

34. 585 F.2d at 238.

35. I.R.C. § 2501. See 585 F.2d at 241.

36. *Johnson v. United States*, 254 F. Supp. 73 (N.D. Tex. 1966).

37. By way of contrast, some regulations are intended to have legislative effect. See, e.g., I.R.C. § 1502 and the regulations thereunder.

38. 585 F.2d at 241-42.

39. *Id.* at 241.

40. *Id.* at 242.

possible to compute the appropriate discount. For example, a five year interest-free note should have a value of about sixty-eight percent of the face amount where the appropriate interest rate is eight percent and the value of the gift upon making the note would thus be thirty-two percent of face value. *Crown* has already been distinguished in a situation involving term notes, and unlike *Crown*, the court found that a taxable event had occurred.⁴¹

There are indications that the Commissioner will take up the invitation to change the regulation. It will be interesting to see whether other circuits follow the Seventh Circuit or will be influenced by a more specific regulation, or indeed, whether the Seventh Circuit itself will change its view in the light of a specific regulation.⁴²

RETROACTIVE DISQUALIFICATION OF A PROFIT SHARING PLAN

If in *Crown* the Seventh Circuit seemed to bend over backward to reach a result favorable to the taxpayer, in *Wisconsin Nipple & Fabricating Corp. v. Commissioner*,⁴³ the court, without much thought, reached an unusually harsh result against the taxpayer. In *Wisconsin Nipple*, the Seventh Circuit affirmed the Tax Court⁴⁴ and approved the action of the Commissioner in retroactively disqualifying a company's profit sharing plan.⁴⁵

The facts in *Wisconsin Nipple* are relatively straightforward. In 1960, the taxpayer had established a profit sharing plan covering only salaried employees and excluding hourly paid employees who apparently had indicated a preference for receiving a cash bonus rather than participating in a deferred compensation plan. The four salaried employees who participated included two officers who were relatively highly paid. The two lower-paid salaried employees were only marginally above some of the fifteen excluded employees in compensation. The Internal Revenue Service approved this plan with a favorable determination letter which, briefly stated, means that the plan qualifies for the favorable tax treatment of a current tax deduction⁴⁶ for the em-

41. *Estate of Berkman v. Commissioner*, 38 T.C.M. (CCH) 183 (1979).

42. For further discussion of the *Crown* case, see Edwards, *What Planning Opportunities Does CA-7's No-Gift-Tax Holding in Crown Open Up?* 50 J. TAX. 168 (1979).

43. 581 F.2d 1235 (7th Cir. 1978).

44. 67 T.C. 490 (1976).

45. Under I.R.C. § 401, a plan is qualified if it meets the requirements of that section, principally relating to nondiscrimination in favor of officers, supervisors and highly compensated employees.

46. See I.R.C. § 404.

ployer coupled with tax deferment for the employees.⁴⁷ In 1962, another determination letter was sought as a result of an amendment to the plan, and again a favorable determination was received by the taxpayer.

During 1973, an Internal Revenue Service agent examined the plan and raised a question about the failure to include hourly employees. In 1971 and 1972, there were six salaried employees participating in the plan and fifteen hourly employees not participating. The participating employees were in general the highest paid employees, although the compensation of many of the excluded hourly employees was close to that of the two lowest compensated of the participants. That same year, the company amended the plan, effective beginning in 1973, to include hourly employees, substituting participation in the plan for their cash bonus. Nevertheless, in 1974, the Internal Revenue Service informed the taxpayer that it was retroactively revoking qualification of the plan for 1971 and 1972, that is, as it stood before the 1973 amendment. The Commissioner's action was based on a revenue ruling⁴⁸ which described a similar situation in which a plan was found not to be qualified.

The Tax Court in *Wisconsin Nipple* held that the Commissioner's action was proper.⁴⁹ The ruling followed a revenue procedure⁵⁰ which placed the responsibility on employers to conform to all such rulings by amending their plans before the end of the year following the one in which the ruling was issued. The Seventh Circuit affirmed the Tax Court's decision.⁵¹

Retroactive disqualification of a profit sharing plan affects the taxes of both the employing corporation and the participating employees.⁵² According to many attorneys handling such matters before the Internal Revenue Service, it is highly unusual for a plan to be disqualified and almost unheard of for the disqualification to be applied retroactively. It is hard to understand how the taxpayer in *Wisconsin Nipple* found itself in this unfortunate situation since there is nothing in the record to indicate any bad faith on its part. The standard of requiring a taxpayer promptly to conform to a ruling which might affect its qualifi-

47. See *id.* § 402.

48. Rev. Rul. 69-398, 1969-2 C.B. 58.

49. 67 T.C. at 495.

50. Rev. Rule 72-6, 1972-1 C.B. 710.

51. 581 F.2d at 1241.

52. In general, if a plan is not qualified, deductions for contributions are allowable to the employer only to the extent benefits are nonforfeitable, and the employee is similarly taxed in the current year.

cation is totally unrealistic. Numerous rulings are issued every year and the applicability of many is not immediately clear. Since the enactment of the Employee Retirement Income Security Act of 1974,⁵³ the requirements for conforming to the law have been exceptionally difficult and the Internal Revenue Service has been quite generous in permitting taxpayers adequate time to conform. Since retroactive disqualification in *Wisconsin Nipple* was not necessary to protect revenue, the result seems harsh. Yet, to a reviewing court, there was probably no choice but to affirm the lower court since the power of the Commissioner to take retroactive action is legally unquestionable.⁵⁴

A SPECIAL LIMITATION FOR MEDICAL EXPENSES WHICH ARE CAPITAL IN NATURE

*Ferris v. Commissioner*⁵⁵ presents a situation involving a rather narrow application of code provisions. *Ferris* is worth examining, however, for the approach taken by the Seventh Circuit. The Ferrises resided in a luxurious house, reflecting a very high standard of material and workmanship. The house was constructed in the English Tudor style of hand-laid and hand-cut stone with servants' quarters and other amenities. In 1970, Mrs. Ferris began to experience difficulty in walking or sitting as a result of a degenerative spinal disorder. Her physician recommended that they install a swimming pool at their residence and that Mrs. Ferris use it regularly to prevent the onset of permanent paralysis.

The Ferrises thereupon constructed a pool area attached to their home, reproducing the stone, roofing and interior design of the residence so as to blend in architecturally with the building. They also included certain other entertainment facilities in this area. The entire addition cost \$195,000. In their tax return, the taxpayers first reduced this amount by about \$22,000 allocable to the other entertainment facilities and then divided the balance of cost approximately in half which their appraiser had estimated was the increased value of the property, resulting in a medical expense of \$86,000 taken on the return.

Capital expenditures generally are not deductible for federal income tax purposes;⁵⁶ however, Treasury regulations have long recognized that an improvement may nevertheless qualify as a deductible

53. Pub. L. No. 93-406, 88 Stat. 829, codified at 29 U.S.C. §§ 1001-1381 (1976).

54. See Comment, *Limits on Retroactive Decision Making by the Internal Revenue Service: Redefining Abuse of Discretion Under Section 7805(b)*, 23 U.C.L.A. L. REV. 529 (1976).

55. 582 F.2d 1112 (7th Cir. 1978).

56. I.R.C. § 263.

medical expense to the extent the expenditure does not increase the value of the related property.⁵⁷ The position taken by the Ferrises on their tax return purported to follow this regulation. The Ferrises computed that portion of their capital expenditure made for a medical need that was in excess of the value added to the property as a medical expense. The Tax Court, with some slight adjustments, held for the taxpayer.⁵⁸ The Commissioner appealed to the Seventh Circuit.

Although there was evidence in the record of the appraiser's estimate of the amount by which this swimming pool addition increased the value of the property, on review the Seventh Circuit did not stop there but felt it necessary to take an additional step to determine if the remaining portion was directly related to medical care.⁵⁹ The Seventh Circuit noted:

The task in cases like this one is to determine the minimum reasonable cost of a functionally adequate pool and housing structure. Taxpayers may well decide to exceed that cost and construct a facility more in keeping with their tastes, but any costs above those necessary to produce a functionally adequate facility are not incurred "for medical care".⁶⁰

The Seventh Circuit remanded the case to the Tax Court for this determination.⁶¹ The Seventh Circuit suggested that the Tax Court could receive evidence of actual cost of other taxpayers who have constructed such therapeutic facilities or it could deduct from the taxpayers' actual cost a sum appropriate to account for the unnecessarily expensive construction which satisfied their personal taste.⁶²

Ferris already has been criticized⁶³ as an unwarranted departure from the regulations which allow as a deduction the portion of the construction cost which does not increase the value of the property. The Seventh Circuit in *Ferris* seemed to carve out a special limitation for medical expenses which are capital in nature since the court recognized⁶⁴ that, in general, taxpayers are not limited in their medical expense deductions to the cheapest form of treatment. Perhaps this limitation is philosophically justified by the extraordinary circumstance of permitting a current deduction for a capital expenditure. Since the

57. Treas. Reg. § 1.213-1(e)(1)(iii)(1974).

58. 36 T.C.M. (CCH) 765 (1977).

59. 582 F.2d 1116-17.

60. *Id.* at 1116.

61. *Id.* at 1118.

62. *Id.* at 1116-17.

63. Pusker, *The Changing Scope of Medical Expense Deductions*, 57 TAXES 347 (1979). *But see* Note, 15 WAKE FOREST L. REV. 114 (1979).

64. 582 F.2d at 1116.

Seventh Circuit conceded the validity of the taxpayers' argument that an esthetically unharmonious facility might well have reduced the value of their property,⁶⁵ the result reached under this standard might well be close to that reached under the regulation. The court in *Ferris* thus established a rule that is difficult to apply since it is based on hypothetical costs and one which creates some confusion on a point that had been thought to be well settled.

The preceding cases are within the so-called "common law of taxation," calling for interpretation of relatively straightforward provisions of the code. These are, of course, often difficult interpretations, but usually do not require extensive tax expertise. The most cogent argument for a national reviewing court for tax cases is that specialized judges will best cope with those cases that involve the most technical provisions of the code. The Seventh Circuit was confronted with several such technical cases during 1978-79.

DEFINING CONTROLLED FOREIGN CORPORATIONS

In 1962, Congress enacted an extremely complex set of provisions⁶⁶ which, in effect, taxes the income of certain subsidiaries directly to the parent corporation.⁶⁷ The provisions were a congressional response to quell the use of foreign tax havens. Central to the imposition of the tax is that the subsidiary be a controlled foreign corporation.⁶⁸ The key element in the definition of a controlled foreign corporation is that fifty percent of the voting power be in the hands of United States persons.⁶⁹ A company with wholly-owned subsidiaries which would be covered by this provision attempted to avoid categorization as a controlled foreign corporation by transferring controlling voting power to an individual or entity which would vote in accordance with the company's wishes. One common device was to create a class of preferred stock with a small capitalization but carrying majority voting power. By a variety of techniques, the United States parent retained effective power to redeem the shares if it became necessary for the parent to

65. *Id.* at 1118.

66. See I.R.C. § 951.

67. The statutory scheme is far more complex, taxing the shareholder's proportionate share of subpart F income as defined in I.R.C. § 952, and its proportionate share of increased investment in United States property as determined under I.R.C. § 956.

68. I.R.C. § 957(a).

69. The term "persons" basically includes United States residents and domestic corporations. I.R.C. § 957(d).

reacquire voting control.⁷⁰

In *Koehring Co. v. United States*,⁷¹ the Seventh Circuit had the opportunity to deal with these highly technical provisions. *Koehring* involved an attempt by the taxpayer-company⁷² to take its foreign sales company out of the classification of a controlled foreign corporation⁷³ so as not to be taxed on the subsidiary's undistributed income. The *Koehring* case presented a more complex issue than that of simply avoiding additional tax because *Koehring* involved an arrangement which had some business purpose in addition to the purpose of avoiding characterization as a controlled foreign corporation. The taxpayer, Koehring Co., had a wholly-owned subsidiary, KOS, incorporated in Panama, which marketed its products. For many years, Koehring also had a relationship with a British company, Newton Chambers Co.,⁷⁴ which had a license to manufacture equipment designed by Koehring, and to market those products primarily in Europe. Koehring and Newton Chambers had discussed previously a concept of a jointly owned international marketing subsidiary.

In 1963, an arrangement was established by which Newton Chambers, for an investment of \$440,000, would acquire KOS preferred stock and have 55 percent of the voting power in KOS. At the same time, Koehring made a similar investment in the non-voting preferred stock of a Newton Chambers subsidiary. Newton Chambers thus had the right to name a majority of the board of directors of KOS, and did so. However, there were very few meetings of the board. Existing management was retained; these people were in fact in charge of the day-to-day operations of KOS, and they were all identified with Koehring. On these facts, the Internal Revenue Service found, and the district court agreed,⁷⁵ that the reality of control was left with the taxpayer, Koehring, and that KOS was a controlled foreign corporation.

The regulations provide that if there is an express or implied agreement that:

Any shareholder will not vote his stock or will vote it only in specified manner, or that shareholders owning stock having not more than 50 per cent of the total combined voting power will exercise power

70. See, e.g., *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974).

71. 583 F.2d 313 (7th Cir. 1978).

72. Hereinafter referred to as Koehring or the company.

73. I.R.C. § 957.

74. Hereinafter referred to as Newton Chambers.

75. 433 F. Supp. 929 (E.D. Wis. 1977).

normally possessed by a majority of the stockholders, then the nominal ownership of the voting power will be disregarded in determining which shareholders actually hold such voting power⁷⁶

The regulations further provide that if the voting power of a class of stock is substantially greater than its share of the earnings or if the facts indicate that the shareholders of this class do not exercise their voting rights independently, the voting power of that class of stock then will be disregarded.⁷⁷

Since the taxpayer did not challenge the validity of the regulations, it was entirely a question of fact whether any express or implied arrangement existed in *Koehring*. Under the circumstances, the Seventh Circuit might well have affirmed the finding of the district court under the clearly erroneous rule.⁷⁸ Instead, the Seventh Circuit chose to examine the issue at some length. The court's analysis reveals a sophisticated understanding of business matters. The court recognized⁷⁹ that the cross-investment by Koehring in a Newton Chambers subsidiary largely mitigated the circumstance of Newton Chambers having made a substantial investment in KOS. The Seventh Circuit also recognized the reality that the business relationship was such that Newton Chambers would not find it wise to exercise independent management control.⁸⁰ Koehring pointed to several instances of Newton Chambers supposedly exercising its control of KOS, but on analysis, these proved to be illusory. Koehring also emphasized that the Newton Chambers' directors had prevented payment of a dividend from KOS. However, there was actually a community of interest here because Newton Chambers' desire to retain funds in KOS for the eventual redemption of its preferred stock coincided with Koehring's tax advantage in avoiding a dividend.⁸¹ In sum, the opinion reflects well on the ability of a general appeals court to consider complicated tax issues.

A WRIT OF MANDAMUS IN A TAX CASE

The Seventh Circuit was on less sure ground when it ordered mandamus in *Vishnevsky v. United States*.⁸² However, the court was careful to limit its decision to the particular facts of the case.⁸³ On July 10,

76. Treas. Reg. § 1.957-1(b)(2) (1963).

77. *Id.*

78. FED. R. CIV. P. 52(a).

79. 583 F.2d at 320.

80. *Id.* at 322.

81. Koehring would hardly have wanted to pay a dividend and thus destroy the tax deferral which it sought to preserve.

82. 581 F.2d 1249 (7th Cir. 1978).

83. *Id.* at 1257.

1972, the taxpayers received a deficiency notice stating certain proposed deficiencies for 1966, 1967, 1969 and 1970 and an overassessment of \$1,400 for 1965. The letter also stated that when a final determination was made on the deficiencies proposed, the overassessment would be scheduled for adjustment to the extent allowable and applied as set forth in section 6402 of the Internal Revenue Code.⁸⁴

The taxpayer in *Vishnevsky* appealed the proposed deficiencies to the Tax Court and at least a portion of the deficiencies were sustained in a decision rendered in September 1974.⁸⁵ When they then sought to have their 1965 overpayment offset against that liability, the Internal Revenue Service refused. The period for filing a refund claim for 1965 had expired in 1973 while the Tax Court proceedings were pending⁸⁶ and the taxpayers, relying on the July 10, 1972 letter, had failed to file a claim for refund. The district director of the Internal Revenue Service took the position that the failure to file the claim deprived him of authority to apply the overassessment as a credit.⁸⁷

Although the taxpayer in *Vishnevsky* filed suit for mandamus relief,⁸⁸ the district court treated the suit as for a tax refund⁸⁹ and granted summary judgment to the government⁹⁰ without considering the propriety of mandamus. The Seventh Circuit considered the mandamus question for the first time, and found itself able to resolve the question without a remand since all of the facts were on record. The court noted that, while the act of determining whether there has been an overpayment is an act of discretion which could not be the subject of mandamus,⁹¹ in *Vishnevsky*, the fact and amount of overpayment have already been determined and it is a ministerial duty of the district director of the Internal Revenue Service to make the credit.

In opposing mandamus, the government argued that while the suit was nominally against government officials calling for a payment from the public treasury, in actuality the suit operated against the sovereign and therefore was subject to sovereign immunity.⁹² The government

84. *Id.* at 1250.

85. John Vishnevsky, 33 T.C.M. (CCH) 1136 (1974).

86. See I.R.C. § 6511(2)(a).

87. See *id.* § 6511(b)(1) (1976).

88. See 28 U.S.C. § 1361 (1976). This provision grants original jurisdiction to the district courts "of any action in the nature of mandamus to compel an officer or employee of the United States or any agency thereof to perform a duty owed to the plaintiff." *Id.*

89. 418 F. Supp. 698 (E.D. Wis. 1976).

90. Summary judgment was granted under 28 U.S.C. § 1346(a)(1) (1976) rather than under 28 U.S.C. § 1361 (1976).

91. *Kalb v. United States*, 505 F.2d 506 (2d Cir. 1974), *cert. denied*, 421 U.S. 979 (1975).

92. See *Dugan v. Rank*, 372 U.S. 609 (1963).

had waived sovereign immunity only in tax refund suits where a claim had been properly filed.⁹³ However, the court observed that in several cases⁹⁴ the Supreme Court has allowed mandamus to compel federal officers to pay money where the duty to do so was clearly ministerial. Furthermore, the fact that jurisdiction for mandamus relief is granted to the district courts⁹⁵ also evidenced a waiver of sovereign immunity.

The result in *Vishnevsky* is tied to the unique facts of the case. The Seventh Circuit in *Vishnevsky* disavowed any intention of encouraging mandamus actions.⁹⁶ Certainly, *Vishnevsky* is not likely to open a floodgate of mandamus litigation in tax matters since there are very few cases where this relief could be appropriate. Yet, until *Vishnevsky*, most tax lawyers would have assumed mandamus would never be available in refund cases because the requirement of filing a claim is jurisdictional. This is essentially the point made by Judge Tone in a dissenting opinion in *Vishnevsky*.⁹⁷ Judge Tone pointed out that if the taxpayers had complied with the procedural prerequisites of filing a claim for refund, the relief would not have been available. The fact that they were misled by the district director's letter did not make mandamus an appropriate remedy when it would not otherwise have been available. It is surprising that in a hardship case such as this, the district court was not able to find an informal claim for refund in some of the taxpayer's correspondence, and thus avoid the jurisdictional issue.⁹⁸

AN UNDERWRITER'S FEE AS AN ESTATE TAX DEDUCTION

In *Estate of Jenner v. Commissioner*,⁹⁹ the Seventh Circuit followed the precedent set by the Ninth Circuit¹⁰⁰ and allowed an underwriting fee as an estate tax deduction.¹⁰¹ A large part of the decedent's estate consisted of stock of a publicly traded company, Baker, Fentress Co.,¹⁰² and the estate's holdings represented more than eleven percent

93. See 28 U.S.C. § 1346 (1976), as construed in *Chapman v. United States*, 485 F.2d 1194 (9th Cir. 1973).

94. See, e.g., *Miguel v. McCarl*, 291 U.S. 422 (1934); *Mellon v. Orinoco Iron Co.*, 266 U.S. 121 (1924).

95. See 28 U.S.C. § 1361 (1976).

96. 581 F.2d at 1257.

97. *Id.* at 1257-58.

98. Some courts have been quite liberal in piecing together informal correspondence from the taxpayer to the Internal Revenue Service as constituting an informal claim for refund. See, e.g., *Tobin v. Tomlinson*, 310 F.2d 648, 652-53 (5th Cir. 1962) (Jones J., dissenting); *Newton v. United States*, 163 F. Supp. 614 (Ct. Cl. 1958).

99. 577 F.2d 1100 (7th Cir. 1978).

100. *Estate of Joslyn v. Commissioner*, 566 F.2d 677 (9th Cir. 1977).

101. See I.R.C. § 2053(a)(2) (allows administration expenses as a deduction).

102. Hereinafter referred to as B-F.

of the stock outstanding. During the course of administration, the executor determined that it would have to raise an additional \$6 to \$9 million in cash to satisfy debts and taxes and to make distributions to the beneficiaries. Because the estate's shares of B-F stock represented such a large block of the outstanding stock of that company, the executor determined that the stock could only be sold through a registered secondary offering, rather than by direct transactions on the over-the-counter market.

According to the terms of the underwriting agreement, the estate agreed to deliver to the underwriters 300,000 B-F shares and the underwriter agreed to pay the estate \$38.85 a share. The estate was also obligated to pay costs and expenses of the registration. The stock was offered to the public at \$42 a share. The \$3.15 a share difference between the price paid by the public and the proceeds to the estate was described as an underwriting discount. In settlement, the underwriter delivered to the executor a check for \$12.6 million representing the \$42 per share paid by the public. The executor in return delivered to the underwriter a check for \$945,000 representing the underwriting discount.

Following its own precedent,¹⁰³ the Tax Court determined that the discount could not be deducted from the estate tax. The Tax Court held that the substance of the transaction was a sale to the underwriter at \$38.85 per share and that the check for \$945,000 to the underwriter was a mere paper transaction which could not be transmuted into a deductible expense.¹⁰⁴

The Seventh Circuit reversed.¹⁰⁵ The court pointed out that if the underwriters had entered into a "best efforts" offering¹⁰⁶ in which they had no firm commitment to buy the stock from the estate, the fee earned by the underwriter would be a deductible expense. The Seventh Circuit did not think a distinction should be made where the underwriters were under a firm commitment to sell the stock at a fixed price.

The result reached by the court in *Jenner* gives the taxpayer what amounts to a double deduction. In valuing the stock as part of the gross estate, consideration is given to the fact that such a large block of

103. The United States Tax Court is not bound by contrary decisions of the courts of appeals outside the circuit in which the taxpayer resides. In *Jack E. Golsen*, 64 T.C. 742 (1970), 445 F.2d 985 (10th Cir. 1971), *cert. denied*, 404 U.S. 940 (1971), the Tax Court adopted the policy of following precedents established by the circuit to which the case could be appealed.

104. See *Estate of Joslyn v. Commissioner*, 566 F.2d 677 (9th Cir. 1977).

105. *Estate of Jenner v. Commissioner*, 577 F.2d 1100, 1107 (7th Cir. 1978).

106. In a best efforts offering, the underwriters agree only to use their best efforts to sell the stock to the public at a favorable price. See *id.* at 1102 n.3.

stock is held that it cannot readily be sold in an ordinary transaction.¹⁰⁷ This so-called blockage rule¹⁰⁸ justifies a deduction of the value to reflect the fact that disposition of the stock could likely be effected only by reducing the price below quoted market values. The estate therefore received both a reduction in value for blockage and the deduction of the underwriting expenses as an administration expense.

A final point which the court had to consider was that under section 2053(a) of the code, administrative expenses are deductible only where they are necessarily incurred in the administration of the estate.¹⁰⁹ State law controls in determining when a sale is necessary for the proper administration of the estate.¹¹⁰ In *Jenner*, the probate court did not directly approve the sale but the executor submitted an accounting to the probate court which showed the \$945,000 as an underwriting discount. The probate court's approval of the accounting was determined to be an implicit finding of the necessity of the sale.

PENALTY FOR LATE FILING

In *American National Bank & Trust Co. v. United States*,¹¹¹ the Seventh Circuit dealt with a rather unusual problem in computing the penalty for late filing of an estate tax return.¹¹² The deceased had purchased over a million dollars of insurance, but the insurance companies were contesting payment on the ground that death occurred by suicide. The executor delayed filing the estate tax return in hope that the insurance claim would be settled, but when no settlement could be reached after nearly three years, it filed a return showing no value for these claims.¹¹³

The estate eventually received a verdict in its favor. The Internal Revenue Service, however, contended that the late filing penalty should be based on the face value of the policies. The district court agreed, but the Seventh Circuit reversed and remanded.¹¹⁴ The Seventh Circuit held that the penalty should be based on the value of the policies as of the date of death.¹¹⁵ This penalty could be determined only by weigh-

107. See Treas. Reg. § 20.2031-2(c) (1958) suggesting that selling prices of small blocks of stock may not reflect fairly the value of a large block.

108. See 577 F.2d at 1103 n.5.

109. I.R.C. § 2053(a).

110. *Ballance v. Commissioner*, 347 F.2d 419, 423 (7th Cir. 1965).

111. 594 F.2d 1141 (7th Cir. 1979).

112. Under I.R.C. § 6651(a), a penalty of 5% of "the amount required to be shown as tax on such return" is added for each month of failure to file, with a maximum penalty of 25%.

113. 594 F.2d at 1143.

114. *Id.* at 1148.

115. *Id.*

ing at that date the contingencies of prevailing in the litigation.

CHARITABLE DEDUCTIONS

*Bowes v. United States*¹¹⁶ involved the determination of the amount of the charitable deduction allowable to the estate for federal estate tax purposes. The decedent's will left to a charitable foundation the entire residue of the estate after certain specific bequests.¹¹⁷ The estate tax is not due until nine months after death.¹¹⁸ During this period, the estate was able to invest the funds it would need to pay the tax and under the will the interest earned was added to the residue to be distributed to the charitable beneficiary. The estate argued, therefore, that the interest earned after death increased the charitable deduction. This argument had been rejected by the district court¹¹⁹ and the Seventh Circuit affirmed¹²⁰ on reasoning similar to the *American National Bank & Trust Co. v. United States*¹²¹ case. The estate tax statute looks to date of death values in determining the amount of the charitable deduction. The result is not unjust since the estate enjoys an income tax deduction for this income which was distributable to charity.¹²²

INVENTORY PRACTICES

Finally, it should be noted that the Seventh Circuit's decision in *Thor Power Tool Co. v. Commissioner*¹²³ discussed in last year's *Seventh Circuit Review*¹²⁴ was affirmed this year by the Supreme Court.¹²⁵ *Thor Power Tool* involved the validity for tax purposes of the common accounting practice of writing down excess parts inventory to reflect the risk of loss attributable to the long period of time before complete disposition of the inventory. The Commissioner had disallowed the write-down and was upheld by the Tax Court¹²⁶ and the Seventh Circuit.¹²⁷ The Supreme Court affirmed, largely on the same reasoning as the Sev-

116. 593 F.2d 272 (7th Cir. 1979).

117. I.R.C. § 2055 permits an unlimited deduction from the taxable estate for amounts distributable to qualified charities.

118. I.R.C. § 6075(a).

119. See 593 F.2d at 274.

120. *Id.* at 276.

121. 594 F.2d 1141 (7th Cir. 1979).

122. See I.R.C. § 642(c)(1).

123. 563 F.2d 861 (7th Cir. 1977).

124. Friedberg & Witt, *Taxation: The Seventh Circuit's Search For Economic Reality*, 55 CHL.-KENT L. REV. 225, 242-45 (1979).

125. 439 U.S. 522 (1979).

126. 64 T.C. 154 (1975).

127. 563 F.2d 861 (7th Cir. 1977).

enth Circuit: the requirement of the regulations that a taxpayer's accounting practice clearly reflect income is paramount over the requirement that it conform to the best accounting practice in the industry.¹²⁸ Thus, the Commissioner's determination that the write-down did not meet this test was not clearly erroneous.¹²⁹ The Internal Revenue Service has shown an increased interest recently in examining taxpayers' inventory practices, and it can be expected to apply *Thor Power Tool* rigorously.¹³⁰

CONCLUSION

It is very difficult to evaluate the Seventh Circuit's performance in deciding tax cases in light of the original inquiry raised in this article concerning the wisdom of establishing a national court of tax appeals. The sample of cases handled in one year is too small to reach any definitive conclusions. Further, this small sample is itself the product of different panels of judges.¹³¹ One premise for the national reviewing court is that a specialized court is needed to deal with the arcane complexities of the Code. The Seventh Circuit has demonstrated its ability to deal with complex statutory patterns, but it appears that relatively few tax cases involve this kind of statutory complexity. Most are relatively straightforward questions of statutory construction not too dissimilar from other areas of federal law. The other premise for establishing a national reviewing court is that it would develop a uniform body of tax jurisprudence. This is a valid consideration since the Supreme Court reviews few substantive tax cases,¹³² but the premise is defeated by Congress' constant tinkering with the Code so that no point of statutory construction can remain settled for long. Perhaps, there is need for a moratorium on tax legislation to give both the bench and bar a chance to catch up. Neither specialized judges nor specialized practitioners can be expected to cope with the flood of legislation that has been passed in the last few years.

128. 439 U.S. at 539. See Treas. Reg. § 1.471-2 (1973).

129. 439 U.S. at 541. See 563 F.2d at 867.

130. For further discussion of the *Thor Power Tool* decision, see Dasburg, Porche & Hannery, *Inventory Valuation After Thor Power: Analyzing the Supreme Court Decision*, 50 J. TAX. 200 (1979); Mikalov, *Inventory Write-Downs & Thor Power Tool*, 57 TAXES 384 (1979).

131. Of the eight cases discussed herein, Judge Pell sat on four panels, Judges Sprecher and Wood on three, and no other circuit judge sat on more than two panels.

132. In the October 1978 term, the Supreme Court decided only three substantive federal tax cases. See *National Muffler Dealers Ass'n v. United States*, 440 U.S. 472 (1979); *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979); *United California Bank v. United States*, 439 U.S. 180 (1978).

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